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Legend

Taxpayer =

Newco =

State X =

State Z =

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Dear :

This is in response to a ruling request, dated September 13, 2007, and supplementary submissions, submitted by your authorized representatives, concerning a wholly-owned subsidiary of Taxpayer, Newco, that will engage in the extended service contract

("ESC") business. Your letter requests a ruling that: (1) the ESCs to be issued by Newco will be insurance contracts for Federal income tax purposes and (2) Newco will be an insurance company taxable under section 831 (a) of the Internal Revenue Code.

Taxpayer is incorporated under the laws of State X and is also headquartered in that state. Taxpayer is the parent of an affiliated group that files a consolidated Federal income tax return. Newco is a member of that affiliated group, and joins in the filing of the consolidated return. Newco is incorporated under the laws of State Z.

Taxpayer designs, develops, manufactures, and markets consumer products. Taxpayer sells products worldwide through its online stores, its retail stores, its direct sales force, third-party wholesalers, resellers, and value-added resellers. A manufacturer's warranty accompanies equipment purchased from Taxpayer. The manufacturer's warranty provides complementary technical support and product service coverage, with some variance in terms depending upon the product covered.

Taxpayer currently offers ESCs with its products. These ESCs may be purchased up to C time from the original purchase date. The terms of the ESCs vary according to the products covered and options selected by the customer. Coverage under the ESCs for product repairs begin after the manufacturer's warranty expires, and for technical support after the initial complimentary technical support period expires.

Taxpayer wishes to move its ESC business to Newco. Taxpayer's management believes that it will be better able to manage the ESC business and comply with regulatory rules applicable to the ESC business if the business is conducted in a separate entity. Having such an entity will also serve to centralize the risk management and administrative functions associated with the ESCs currently offered by Taxpayer to achieve administrative and program design efficiencies.

Newco will not be recognized as an insurance company under the laws of State Z. Newco will initially be capitalized with at least \$E, or more, if state laws governing the issuance of ESCs so require. Newco will not assume any of Taxpayer's existing ESCs.

The ESCs will be issued and administered by Newco. Newco will only issue contracts when it is the named contractual administrator and obligor. Newco does not intend to serve as administrator on ESCs when Newco is not the obligor. For a separately stated charge, customers of Taxpayer may purchase an ESC for either an F year or G year period, depending on the product. The ESC will be issued by Newco under a separate service contract apart from the applicable basic technical support and standard warranty. A purchaser of an ESC's only recourse under an ESC will be with Newco.

For an arms length consideration, Newco expects to purchase reinsurance from an affiliated company for all or a portion of the risks on the ESCs issued by Newco. Taxpayer represents that the affiliated company will be a licensed State Z captive

insurance company. The terms of the reinsurance agreement should include customary insurance industry terms and conditions.

Newco will have no direct employees and will contract with third parties and affiliates to perform all of its administrative functions including record keeping, claims administration, and adjusting functions, assisting Newco in updating and modifying rates, and compliance with state regulatory rules and filing requirements. Newco will have officers and directors who will have oversight responsibility for these functions.

Newco will be the obligor and administrator of the ESCs. However, Newco will not sell the ESCs directly to purchasers of Products. The ESCs will continue to be sold through Taxpayer's retail stores. Newco will also enter into selling agreements with third-party wholesalers, resellers, and value-added resellers. Newco will establish suggested retail prices for the ESCs at what is believed to be a fair market value for the service and support offered, but ESCs may be sold by the third parties resellers to customers at negotiated prices.

Newco may service customer claims through one or more of the following options: carry-in service to a Taxpayer-owned retail store, Authorized Service Providers, direct mail-in service, or do-it-yourself parts service. Under the ESCs, Newco will be obligated to pay for the cost of repair or replacement for products (and, with certain products, the included accessories and additional features) and the cost of providing technical support during the periods of coverage under the ESCs. Newco will not be liable for all damages. The service coverage is subject to the limitations listed in the ESC for the specific product. Newco will not itself perform any repair services to products.

Taxpayer represents that there will be no overlap between Taxpayer's manufacturer's warranty and the ESCs offered by Newco. Newco's ESCs will be compliant with state law requirements. Taxpayer is unaware of any states where by law the manufacturer's warranty never expires or where it may be extended by law beyond the stated period/term. However, certain states prevent sellers from disclaiming the UCC implied warranties of merchantability and fitness for a particular purpose. The anti-disclaimer statutes that are present in these states do not themselves extend the rights that are described under a manufacturer's voluntary warranty. In the event a state law mandates additional coverage under the manufacturer's basic warranty, the Newco ESC contract will exclude such coverage.

Newco will offer the ESCs in numerous states. It anticipates selling a substantial volume of ESCs based upon Taxpayer's experience in selling ESCs.

The terms and conditions of the ESCs define what occurs when a holder cancels a contract before expiration. Customers can cancel contracts at any time for any reason unless local law provides otherwise. If the contract is terminated within the first 30 days, the customer receives a full refund of the purchase price less the value of any service provided under the plan. If the contract is terminated after 30 days, the customer

receives a pro rata refund of the purchase price based on the contract term less a cancellation fee of \$H or I% of the pro rata amount, whichever is less, and less the value of any service provided under the contract. If Newco cancels the contract, the customer will receive a pro rata refund for the unexpired term of the contract.

One of Newco's income-producing activities will be investing premiums to pay claims and produce surplus. However, Taxpayer represents that a substantial majority of Newco's gross receipts will be derived from issuing ESCs.

LAW AND ANALYSIS

Section 831 (a) of the Code provides that taxes, as computed under section 11, will be imposed for each taxable year on the taxable income (as defined by section 832) of each insurance company other than a life insurance company.

Section 831 (c) defines the term "insurance company," for purposes of section 831, as having the same meaning as the term is given under section 816(a).

Section 816(a) provides that the term "insurance company" means any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

Section 1.831-3(a) of the Income Tax Regulations provides that for purposes of section 831 and 832, the term "insurance company" means only those companies that qualify as insurance companies under the definition of former section 1.801-1 (b) (now section 1.801-3(a)(1)).

Section 1.801-3(a)(1) provides that although the company's name, charter powers, and subjection to state insurance laws are significant in determining the business that a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year that determines whether the company is taxable as an insurance company under the Internal Revenue Code. See also, Bowers v. Lawyers' Mortgage Co., 285 U.S. 182, 188 (1932) (to the same effect as the regulation); Rev. Rul. 83-172, 1983-2 C.B. 107 (holding that taxpayer was an insurance company as defined in section 1.801-3(a)(1), notwithstanding that taxpayer was not recognized as an insurance company for state law purposes). To qualify as an insurance company, a taxpayer "must use its capital and efforts primarily in earning income from the issuance of contracts of insurance." Indus. Life Ins. v. United States, 344 F. Supp. 870, 877 (D.S.C. 1972), affd per curiam, 481 F. 2d 609 (4th Cir. 1973), cert. denied, 414 U.S. 1143 (1974). To determine whether a taxpayer qualifies as an insurance company, all relevant facts will be considered, including but not limited to, the size and activities of its staff, whether it engages in other trades or businesses, and its sources of income. See generally, Bowers, 285 U.S. 182, Indus. Life Ins. Co., at 875-77; Inter-Am. Life Ins. Co. v. Commissioner, 56 T.C. 497, 506-08 (1971), affd per curiam, 469 F 2d 697 (9th Cir. 1971).

Neither the Code nor the regulations thereunder define the term "insurance" or "insurance contract." The accepted definition of "insurance for Federal income tax purposes relates back to Helvering v. Le Gierse, 312 U.S. 531, 539 (1941), in which the Supreme Court stated that "[h]istorically and commonly insurance involves risk-shifting and risk-distributing." Case law has defined "insurance" as "involving] a contract, whereby, for adequate consideration, one party undertakes to indemnify another against loss arising from certain specified contingencies or perils... [I]t is contractual security against possible anticipated loss." See Epmeier v. United States, 199 F. 2d 508, 509-10 (7th Cir. 1952). In addition, the risk transferred must be risk of economic loss. Allied Fidelity Corp. v. Commissioner, 572 F. 2d 1190, 1193 (7th Cir. 1978), cert. denied, 439 U.S. 835 (1978). The risk must contemplate the fortuitous occurrence of a stated contingency. Commissioner v. Treganowan, 183 F. 2d 288, 290-291 (2d Cir. 1950), and must not be merely an investment or business risk. Le Gierse, 312 U.S. at 542; Rev. Rul. 89-96, 1989-2 C.B. 114, as amplified by Rev. Rul. 2007-47, 2007-30 I.R.B. 127.

Risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer. See Rev. Rul. 92-93, 1992-2 C.B. 45 (when parent corporation purchased a group-term life insurance policy from its wholly owned insurance subsidiary, the arrangement was not held to be "self-insurance" because the risk of economic loss was not that of the parent), modified on other grounds, Rev. Rul. 2001-31, 2001-1 C.B. 1348. If the insured has shifted its risk to the insurer, then a loss by the insured does not affect the insured because the loss is offset by the insurance payment. See Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987).

Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken as premiums and set aside for the payment of such claim. Insuring many independent risks in return for numerous premiums serves to distribute risk. By assuming numerous, relatively small, independent risks that occur randomly over time, the insurer can smooth out losses to match more closely its receipt of premiums. See Clougherty Packing Co. v. Commissioner, 811 F. 2d at 1300.

The "commonly accepted sense" of insurance derives from all the facts surrounding each case, with emphasis on comparing the implementation of the arrangement with that known to be insurance. Court opinions identify several nonexclusive factors bearing on this, such as the treatment of an arrangement under the applicable state law, AMERCO v. Commissioner, 96 T.C. 18, 41 (1991); the adequacy of the insurer's capitalization and utilization of premiums priced at arm's length, The Harper Group v. Commissioner, 96 T.C. 45, 60 (1991), aff'd, 979 F. 2d 1341 (9th Cir. 1992); separately maintained funds to pay claims, Ocean Drilling & Exploration Co. v. United States, 24 Cl. Ct. 714, 728 (1991)., aff'd per curiam, 988 F. 2d 1134 (Fed. Cir. 1993); and the

language of the operative agreements and the method of resolving claims, Kidde Indus. Inc. v. United States, 49 Fed. Cl. 42, 51-52 (1997).

CONCLUSIONS

Based on the information submitted, we conclude that, in its initial taxable year, and in each taxable year that the facts are similar, Newco's ESCs will be insurance contracts for Federal income tax purposes. The ESCs are aleatory contracts under which Newco, for a fixed price, is obligated to indemnify the contract holder for certain economic losses, which are not covered by the manufacturer's warranty. Thus, during the contract period, the contract holder limits its loss for covered risks to the payment of the contract purchase price. In this way, each contract holder shifts the risk of economic loss to Newco. By issuing ESCs to a large number of contract holders, Newco will assume numerous, independent, and homogenous risks. Newco will have distributed the risk of loss under the ESCs so as to make its average loss predictable.

Based upon Taxpayer's representation concerning Newco's business activities, we find that more than half of Newco's business will be issuing ESCs that are insurance contracts for Federal income tax purposes. Therefore, Newco will qualify as an "insurance company" for purposes of section 831 in its initial taxable year, and in each taxable year in which more than half of its business will be issuing ESCs that are insurance contracts for Federal income tax purposes.

CAVEATS

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

/S/

Sheryl B. Flum
Chief, Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)

cc: